Are Global Imbalances a Problem?

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The Most Controversial Issue

- Not the size of the imbalances
- Nor how to remedy them if they need to be remedied (demand rebalancing and dollar devaluation against East Asia)
- But whether they constitute a policy problem that demands action
- The do-nothing view versus activism
- Easy task because JW and audience both favor activism
- Nevertheless, it is important to understand the do-nothing view

Structure of the Paper

- Outline of do-nothing view
- Discussion of three central tenets of the do-nothing view:
  - The view that on present trends a gradual adjustment is likely, or else that the market will automatically induce a gradual adjustment in its own good time
  - The view that a deliberate attempt to achieve adjustment would face irreconcilable problems of conflicting national interests
  - The view that the organizational problems of concerting adjustment policies are so formidable as to preclude this solution
- Argument for believing that a deliberate concerted adjustment is to be desired.

The Do-Nothing View

- Version of Richard Cooper in forthcoming BPEA
- Measurement of savings—relevant to thesis that US is undersaving, but not to S-I
- Actual 2006 capital inflow was smaller than it would have been with no home bias
- Natural for US to have c/a deficit because of demographic difference
- US ability to continue supplying financial assets because although these are 89% of US GDP they are less than 9% of US financial assets, much less than if a “neutral” 30% share of foreign assets were held in the USA.

The Do-Nothing View II

- Difficulties of RoW in adjusting:
  - Many economies (notably China, Germany, Japan) are export-oriented, so reduction in demand in the US would be likely to curtail their demand too
  - Widespread desire for fiscal consolidation
  - Monetary easing could be perverse via exchange-rate effect
  - Lisbon Agenda focuses on improving competitiveness, not raising demand

Eventually corrective forces will set in (or maybe already have), as globalization slows and societies age, leading to a fall in the US deficit.

Automatic Adjustment versus Crisis

- Two sub-variants of the Do-Nothing view:
  - Adjustment has already started
  - Adjustment will happen automatically when RoW desires additional resources
- The first version is factually correct, but unsurprising and indeed gratifying to a believer in received theories of the c/a
- But will the improvement be sustained?
- Three factors making for a trend deterioration:
  - The “gap” factor
  - Any Houthakker-Magee asymmetry in the trade elasticities
  - Increasing burden of debt service
- It is only if the current improvement leads to a US c/a surplus that the first and third factors would turn positive.

Automatic Adjustment versus Crisis II

- Alternative Variant: Adjustment will happen when RoW desires to stop saving dollar assets as globalization is completed and/or ageing increases
- There is no impediment to dollar devaluation and RoW demand increase
- This benign view is possible
- But the alternative of a Dollar Crisis, with a sharp dollar depreciation and a confidence collapse reducing US consumption and investment, is also possible
- In the US, expenditure-reduction would eventually be outweighed by expenditure-switching effect of dollar depreciation
- In RoW, the two would be mutually reinforcing and threaten a world recession
- This is NOT a certainty, but prudence counsels adjustment policies if the potential consequences of do-nothing are sufficiently severe.

Conflicting National Interests I

- Most acute form is “Bretton Woods II”: the assertion that Chinese growth and employment expansion depends on export-led growth, which China will not sacrifice to achieve prompt adjustment
- Three errors:
  - Association of export-led growth with large c/a surpluses. Remember the E. Asian NIEs before 1997 crisis.
  - Belief that bigger undervaluation is better for growth. Fallacy is that it overlooks the potential supply-side benefits and inflation-fighting potential of c/a deficits
  - Association of rapid GDP growth with fast employment creation. Chinese counter-example: GDP growth of 10%, employment growth of 1%. Bigger demand for services could in fact augment employment creation.

Conflicting National Interests II

- Case for adjustment not equally clear in all major surplus countries
- Notably Japan, where one still has to worry about demand deficiency (though less than before the growth resumption), and so slower adjustment would be reasonable
- And the oil exporters, which are adjusting already, and the saving in prospect does not seem uneconomically high
- And Germany, which is part of euro area, in which Spain's deficit leads to overall near-balance
- But there are enough countries like China, in which prompt adjustment would be in the national interest, to match adjustment of the US current account deficit.

Concerting Adjustment Plans I

- Concertation is essential: half an adjustment could be worse than none (e.g. leading to world recession or inflation)
- The do-nothing view asserts that there is no international mechanism that could plausibly be deployed to get countries to commit to change policies simultaneously (G7 is outmoded, since China is not a member)
- But the multilateral consultations designed by the last MD of the IMF were exactly the right instrument: right members, right context, right topic
- The errors were (a) to accept the customary bromides for an answer; and (b) to start negotiations without the necessary US commitment that it was prepared to change policy as part of a package, not just be a demandeur.

Concerting Adjustment Plans II: How To Do It

- Start with multilateral consultations only when the conditions for success are in place
- Four outcomes of a successful negotiation:
  - Both demand (fiscal policy) and exchange rates need to be on the table, although the exchange rates of some countries are not a policy weapon
  - If world demand is right to begin with, demand needs rebalancing, not changing
  - Effective and dollar appreciation for most of East Asia
  - At most dollar appreciation for most non-East Asian currencies
- Supportive regional negotiations, at least in East Asia, to classify countries into
  - those appreciating with China and Japan
  - those not expected to appreciate further in effective terms
  - an intermediate group
- Ideally side agreements to discipline “verbal intervention” and reform the exchange rate policy of the Gulf oil-exporters.

Concluding Remarks

- Argument has been that active programme of adjustment would reduce the risk of disaster
- That the dangers of incompatible national interests are erroneous
- That a mechanism for gaining acceptance of such a programme already exists, once the preconditions are in place
- And hence that we should not accept for the nth time reassurances that this time is different and we live in a brave new world where adjustment will be automatic. Maybe so, the chances not.